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ABSTRACT

An independent audit was done of the principal financial statements of the William D. Ford Federal Direct Loan Program of the Department of Education for the year ending September 30, 1994. In planning and performing the review the auditors considered the internal control structure of the program in order to determine auditing procedures. The report on internal control structure disclosed conditions existing during fiscal year 1994 which were considered reportable. Specifically, the auditors reported controls within the Direct Loan Program's loan origination, servicing, and reporting systems that needed improvements. These were not, however, considered to be material weaknesses. Recommendations for improvements were offered in the following areas: (1) reconciliation and reporting efforts to ensure loan origination data accuracy and prompt recording and receiving at the Department; (2) improved ability to monitor cash management to reduce potential risk of excess cash balances at schools; (3) improved school level controls (inaccurate and incomplete records were found at visits to seven participating schools). In an examination of the program compliance with laws and regulation, the auditors found positive assurance of compliance with laws and regulations for items tested. The program's principal financial statements are included in the Financial Report section. Appended is a management response to the audit recommendations. (JB)

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Office of Inspector General

Office of Audit

FINANCIAL STATEMENT AUDIT

U.S. DEPARTMENT OF EDUCATION
FEDERAL DIRECT STUDENT LOAN PROGRAM
FOR THE YEAR ENDED SEPTEMBER 30, 1994

AUDIT CONTROL NUMBER 17-48320

MARCH 1995

U.S. DEPARTMENT OF EDUCATION
Office of Educational Research and Improvement
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DIRECTOR, ACCOUNTING AND
FINANCIAL MANAGEMENT STAFF
WASHINGTON, D.C.



U.S. DEPARTMENT OF EDUCATION

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HE 028 218



UNITED STATES DEPARTMENT OF EDUCATION
OFFICE OF INSPECTOR GENERAL

March 17, 1995

Honorable Richard W. Riley
Secretary of Education
Washington, D.C. 20202

Dear Mr. Secretary:

This report presents the opinion on the Department of Education's William D. Ford Federal Direct Loan Program Principal Statements for the fiscal year ended September 30, 1994. Reports on the William D. Ford Federal Direct Loan Program's internal control structure and on its compliance with laws and regulations are also provided.

The Office of Inspector General (OIG) contracted with Urbach Kahn & Werlin, PC (UKW), Certified Public Accountants, to perform the audit. The OIG monitored the progress of the audit, reviewed supporting workpapers and performed other procedures deemed necessary to ensure compliance with the Chief Financial Officers (CFO) Act of 1990.

It is the opinion of UKW that the William D. Ford Federal Direct Loan Program's Principal Statements present fairly, in all material respects, its financial position as of September 30, 1994, the results of its operations and changes in net position, cash flows, and budgetary resources and actual expenses for the year then ended (page 9).

The UKW report on the William D. Ford Federal Direct Loan Program internal control structure disclosed no material weaknesses in internal controls; however, it did disclose conditions existing during fiscal year 1994 which UKW considered to be reportable. Specifically, UKW reported that controls within the program's loan origination, servicing and reporting systems need improvement and offered recommendations for improving the internal control structure (pages 10-15).

Meeting the aggressive legislative timeframes for systems development and program implementation was a significant challenge that the Department has accomplished. Given the short time frame, complete, comprehensive testing of the program's systems could not be accomplished prior to commencing first year operations. As the program expands from five percent to approximately 40 percent (a direct loan volume increase of 700 percent) of the existing Federal Family Education Loan Program volume, it is important that management focus on improving the controls addressed by the recommendations in order to ensure better accountability and control over program operations.

The UKW report on compliance with laws and regulations disclosed nothing to indicate that the William D. Ford Federal Direct Loan Program had not complied with applicable laws and regulations which could have a material effect on the financial statements (page 16).

The 1994 financial statement audit was conducted in accordance with generally accepted auditing standards, *Government Auditing Standards*, issued by the Comptroller General of the United States, and the provisions of Office of Management and Budget (OMB) Bulletin 93-06, *Audit Requirements for Federal Financial Statements*. The Principal Statements were prepared in accordance with OMB Bulletin 94-01, *Form and Content of Agency Financial Statements*, which is considered to be a comprehensive basis of accounting other than generally accepted accounting principles.

The Department's management is responsible for preparing the Annual Financial Statements in conformity with applicable standards, establishing and maintaining internal controls and systems, and complying with applicable laws and regulations. Annual Financial Statements as described in the CFO Act are comprised of the Overview, the Principal Statements, and where applicable, Combining Statements and Supplemental Financial and Management Information.

The auditors are responsible for obtaining reasonable assurance about whether (1) the Principal Statements are reliable (free of material misstatements and presented fairly in accordance with applicable accounting principles); (2) the program has an internal control structure that provides reasonable assurance of achieving the internal control objectives described in OMB Bulletin 93-06; (3) the program has complied with significant provisions of selected laws and regulations; and (4) the information and manner of its presentation in the Overview are materially inconsistent with the information in the Principal Statements. OMB Bulletin 94-01 further describes the Overview and other components of Annual Financial Statements.

During the course of its audit UKW identified other matters which are not reportable but nevertheless warrant management's attention. These are being communicated in a separate letter for management's consideration.

The results of the audit were discussed with members of your staff throughout the audit. The combined responses of the Offices of the Chief Financial Officer and Postsecondary Education to the findings and recommendations presented in the draft audit report have been included as Appendix 1. Based on the response, management is in general agreement with the issues raised in the report.

In accordance with the Freedom of Information Act (Public Law 90-23), reports issued by the Office of Inspector General are available, if requested, to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act.

We appreciate the cooperation given us and UKW in the audit.


Steven A. McNamara
Assistant Inspector General
for Audit

Enclosure

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HIGHLIGHTS OF AUDIT RESULTS

Urbach Kahn & Werlin PC (UKW) was contracted by the Office of Inspector General (OIG) of the Department of Education (the Department) to perform an audit of the principal financial statements of the William D. Ford Federal Direct Loan Program (Direct Loan Program) of the Department as of and for the year ended September 30, 1994. The audit was required under the Chief Financial Officers Act of 1990.

Independent auditor's report

UKW issued an unqualified opinion on the statements of financial position, operations and changes in net position, cash flows and budgetary resources and actual expenses for the year ended September 30, 1994.

Independent auditor's report on internal control structure

In planning and performing the audit of the principal financial statements of the Direct Loan Program for the year ended September 30, 1994, UKW considered its internal control structure in order to determine the auditing procedures for the purpose of expressing an opinion on the principal financial statements and not to provide assurance on the internal control structure.

The report on internal control structure disclosed conditions existing during fiscal year 1994 which UKW considered to be reportable (see page 10). Specifically, UKW reported controls within the Direct Loan Program's loan origination, servicing and reporting systems need improvement. These reportable conditions were not considered to be material weaknesses. UKW provided recommendations for improvements in the following areas:

Reconciliation and reporting efforts - Improvements need to be made in the Program's process for assuring loan origination data is accurate, and promptly recorded and received by the Department. (See page 13)

Ability to monitor cash management - Improvements are necessary in the Department's ability to monitor institutions' cash management. Although there were no instances of excess cash identified at seven schools visited, the potential risk of undetected excess cash balances would be diminished if the Direct Loan Program reconciled specific advances for each month with specific loans disbursed for that month. (See page 14)

School level controls - Improvements are necessary in the Department's ability to promptly identify and resolve school level problems. During reviews conducted at seven schools participating in the Direct Loan Program, there were incomplete or inaccurate supporting documentation in student files, mistakes in various financial aid and academic file documentation, and problems with system software and hardware. (See page 14)

UKW's recommendations to address these reportable conditions are provided on page 11. UKW believes implementing these recommendations would enhance the Department's ability to manage this growing program.

The Department is in general agreement with the need to improve controls in the processes discussed in this report. It recognized there would be start-up issues identified while implementing this program due to the short period of time it had to make it fully operational and has identified and already started implementing activities to improve controls for the issues raised.

HIGHLIGHTS OF AUDIT RESULTS, CONTINUED

Independent auditor's report on compliance with laws and regulations

UKW issued an unqualified report on the Direct Loan Program's compliance with laws and regulations, issuing positive assurance of compliance with laws and regulations for items tested, and negative assurance of compliance with laws and regulations for items not tested.

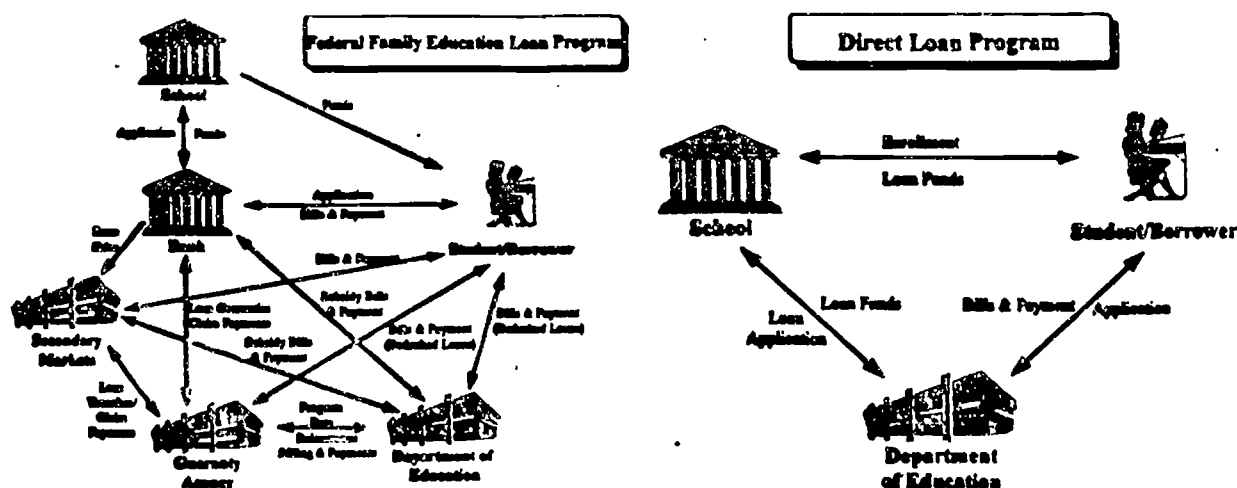
OVERVIEW OF THE REPORTING ENTITY

OVERVIEW OF REPORTING ENTITY

Mission and Objectives

The William D. Ford Federal Direct Loan program (Direct Loans) was enacted by Congress to improve Federal student loan program performance for student and parent borrowers, institutions, taxpayers and the Federal government over the existing Federal Family Education Loan (FFEL) program. The primary goals of Direct Loans are to provide borrowers and participating schools with greater flexibility and more efficient service than is available under FFEL within a simple, more automated and accountable system, while at the same time save Federal taxpayers billions of dollars.

As depicted below, Direct Loans is very simple when compared to FFEL. In FFEL there are more than 7,500 private lenders, 45 guaranty agencies and 90 participants in the secondary market, who receive subsidies from the government for special allowances, interest benefits, administrative expense allowances and default claims. The schools and borrowers have to navigate through a complex maze of unique policies, forms and deadlines for each lender and guaranty agency. This process often results in confusion and delays that ultimately cause defaults. On the contrary, Direct Loans has only three players: the borrower, the school and the Department of Education (Department). The Department contracts with the private sector to provide origination, servicing and accounting systems and perform related services. This private sector involvement meets with current management standards of finding ways to improve performance at less cost.



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When compared with FFEL, Direct Loans provides a number of advantages for borrowers, schools, taxpayers and the Federal government.

Benefits for borrowers:

Direct Loans afford students several customer service features not provided by FFEL:

- **Simplicity and speed in obtaining loans.** Direct Loan borrowers complete one application form for all Department student financial aid programs (e.g., PELL Grants). Processing time is reduced through electronic data and funds transfer, often shortening or eliminating student lines in financial aid and business offices. The reduction of paperwork has raised the level of service that students receive. Schools have time to deal with more important issues such as counseling students on financial aid. In FFEL, borrowers must apply for loans separately from other student aid through participating lenders.
- **Timely delivery of funds to borrowers.** Students don't wait in lines to endorse bank checks because schools receive loan funds electronically from the Department. This eliminates the need to wait for loan proceeds and reduces paperwork. Schools find they do not have to field calls from anxious students attempting to track down loan funds from different lenders.
- **Students borrow only what they need.** Direct Loan borrowers know they can receive additional money quickly and easily. Under FFEL, students borrow the maximum available to avoid long delays in receiving loan funds.
- **Loans will not be sold.** The Department is the only lender in Direct Loans. FFEL loans are typically sold (sometimes several times) and most borrowers have several loans. Borrowers frequently report confusion about where to send their loan payments and deferment and forbearance forms.
- **One-stop repayments.** Direct Loan borrowers make one payment for all Direct Loans to one place—the Department's Direct Loan Servicing Center. Regardless of the number of loans or the place of origination, Direct Loan borrowers send a single monthly check to one place throughout the life of the loans—substantially reducing borrower paperwork, confusion, and opportunities for error. In FFEL, borrowers write and send several checks to various lenders and secondary market participants.

- **One-stop deferments and forbearances.** Borrowers do not have to seek deferments and forbearances from multiple lenders and/or guaranty agencies. Once a deferment or forbearance form is received from the borrower, the Department will apply them to all of the borrower's appropriate Direct loans.
- **Varied repayment options.** Borrowers may easily choose from a variety of repayment options, including income-contingent repayment. These flexible repayment options encourage Americans to pursue postsecondary education by minimizing the risk of burdensome monthly payments and potential defaults, and at the same time afford students greater freedom to consider lower-paying careers, such as public service.

Benefits for schools:

This streamlined program has given schools the capability to perform activities more effectively and efficiently than under FFEL:

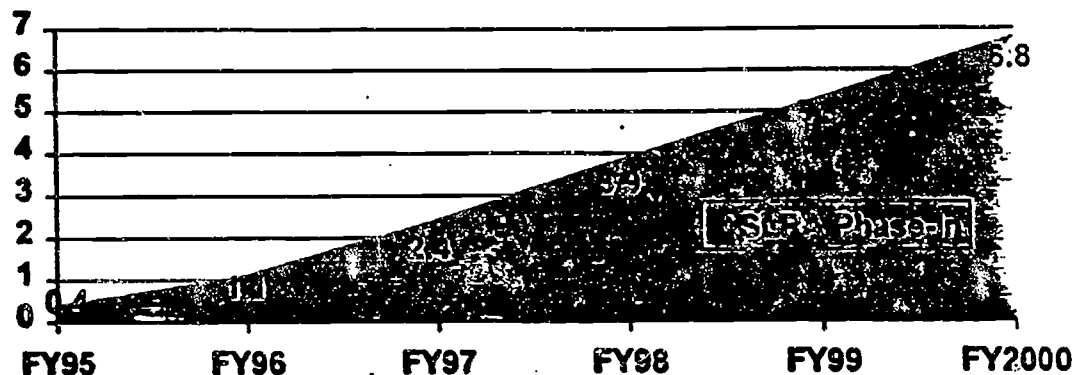
- **Flexibility for schools.** Schools decide how much administrative responsibility they wish to assume, determine the division of work between financial aid and business offices and decide how they will carry out their day-to-day operations.
- **Schools have control over the loan process.** Questions from students and parents can be answered quickly and accurately. Schools know when funds will be received from the Department and know within a few days if records and promissory notes have been accepted.
- **Electronic transfer of funds from a single source.** Schools do not wait for or process checks from multiple lenders. Cash flow at schools is greatly improved, which reduces or eliminates their need for short-term, emergency loans for students.
- **Reduced paperwork.** Duplicate paperwork under FFEL is replaced by one application, one source of funds and one servicing center. All loan information, except for the promissory note, is transmitted and acknowledged electronically.
- **Streamlined and simplified administration.** Schools can disburse loan proceeds and adjust loan amounts much more quickly and efficiently, because they no longer need to obtain lender and guaranty agency approvals.

Benefits for taxpayers:

As illustrated in the chart below, the Department estimates the Student Loan Reform Act (SLRA) of 1993 will save taxpayers \$6.8 billion from fiscal years 1995-2000. The \$6.8 billion savings estimate was derived by comparing the most current combined Direct Loans and FFEL cost estimates, including SLRA with current estimates for FFEL, exclusive of SLRA:

**Savings Projected by Fiscal Year
Student Loan Reform Act of 1993
(in billions)**

Dollars



These savings result from several inherent advantages of the Direct Loan program:

- **Savings from reduced subsidy payments in FFEL.** Under FFEL, the Federal Government pays lenders and guaranty agencies substantial interest subsidies and administrative allowances to assure continued participation in the program. In fiscal year 1995, for example, the government estimates it will pay banks more than \$600 million in special allowance payments tied to the 91-day Treasury bill rate, which provide them a guaranteed rate of return on student loans. Under Direct Loans, such payments are no longer necessary.
- **Savings from borrower interest repayments.** Borrower interest repayments, particularly under the Unsubsidized Stafford and PLUS loan programs, usually exceed the cost of Federal borrowing under Direct Loans. This interest income partially offsets the cost of the program.
- **Savings from Direct Loans origination and servicing.** Direct Loan origination and servicing will be performed under contract to the Department to take advantage of competitive bidding. In the FFEL

program, lenders and guaranty agencies receive statutorily mandated payments for these activities that are not related to their costs.

Direct Loan benefits for the Department of Education:

The Department designed and implemented Direct Loans to improve program accountability, which gives the Department benefits not provided by FFEL:

- **Increased accountability.** The Department has centralized the loan information and standardized the format of loan data received from all schools. The substantial reduction in program complexity and the number of transactions and middlemen leads to fewer opportunities for error and abuse, and greatly reduces the risk of accidental default.
- **Reduced paperwork.** All loan information, except for the promissory note, is transmitted and acknowledged electronically. The Department is using state of the art technology to replace some of the manual processes and forms used in FFEL.
- **Improved capacity to manage.** Under the new streamlined system, the Department is able to monitor more effectively the far more limited number of servicers participating in the program, as well as institutional compliance with program requirements.

Implementation of the Program

On August 10, 1993, the Student Loan Reform Act (SLRA) of 1993, part of the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) authorized the Federal Direct Student Loan Program. The Program was renamed the William D. Ford Federal Direct Loan Program on October 20, 1994 (P.L. 103-382). The Secretary of Education selected 104 schools (with 113 campus locations) to become the first participants during the first year of this program from a pool of over 1,100 applicant institutions. As of September 30, 1994, 103 schools participated. For the second year, a total of 1,495 institutions have been selected into the program.

The schools selected for the first year are located in 45 states and 2 territories and as mandated by legislation, the loan volume of these institutions represents approximately five percent of the total new student loan volume estimated for the 1994-95 academic year. For academic year 1995-96, Direct Loans will represent up to 40 percent of new loan volume; for 1996-97 and 1997-98, at least 50 percent and beginning with academic year 1998-99, at least 60 percent.

After passage of the SLRA, the Department had only 11 months to prepare for full national implementation. The Department was able to meet all of its regulation, contracting, system development and testing and accounting deadlines in this short time span. As part of this development the Department provided software, training, instructional materials, program information, and technical and program assistance, both on and off-site to institutions free of charge.

On July 1, 1994, Direct Loans became fully operational and as of September 30, 1994, had booked approximately 200,000 loans, totaling \$400,027,958 to parent and student borrowers. The total dollar amount of loans booked by program consists of \$260,082,679 for Stafford, \$105,287,955 for Unsubsidized Stafford and \$34,657,324 for PLUS.

Program Description

Origination of loans

In the first year schools participate in Direct Loans in one of two ways:

- **Originating Schools.** These schools originate loans through their financial aid offices, drawing down funds to cover their immediate needs directly through the Department's Payment Management System. Originating schools are paid an administrative fee for origination of \$10 (if the school prints the promissory notes) or \$7 (if the servicing contractor prints the promissory notes) per borrower. Schools receive this fee only after each borrower's first disbursement has been reconciled between the school and the Direct Loan Servicing Center.
- **Alternate Originating Schools.** These schools use an alternate originator under contract with the Department to request the drawdown of loan funds. The alternate originator bases its request for funds on loan origination records and signed promissory notes received for individual borrowers. Schools may only disburse funds specified for each borrower. Any funds not disbursed to each borrower must be returned to the Department. These schools do not receive an administrative fee.

Loan limits

The maximum annual amount a student may borrow is defined by the school's costs, other financial aid the student is receiving and, for subsidized loans, the expected family contribution. The maximum annual combined amounts of subsidized and unsubsidized loans that dependent and independent students may receive are as follows:

	<u>DEPENDENT</u>	<u>INDEPENDENT</u>
1st Year Undergraduate	\$2,625	\$6,625
2nd Year Undergraduate	3,500	7,500
3rd & 4th Year Undergraduate	5,500	10,500
Graduate/Professional	N/A	18,500

Loan types

The Direct Loan Program provides the following types of loans to parent and student borrowers:

- **Federal Direct Stafford/Ford (Stafford) Loans**, are subsidized, low interest loans based on financial need. The Federal government pays the interest while the student is in school and during grace and deferment periods.
- **Federal Direct Unsubsidized Stafford/Ford (Unsubsidized Stafford) Loans**, are also low interest student loans. Under this program the Federal government does not pay interest for the student during in-school, grace, and deferment periods.
- **Federal Direct PLUS (PLUS) Loans**, are available to parents of dependent undergraduate students. The maximum interest rate for PLUS loans is higher than for Stafford and Unsubsidized and the Federal government does not pay interest for the student during in-school, grace, and deferment periods.
- **Federal Direct Consolidation (Consolidation) Loans** allow borrowers with federal education loans who meet certain criteria to combine their obligations and extend their repayments schedules. There were no Direct Consolidation loans as of September 30, 1994.

All loans have variable interest rates, capped at 8.25 percent for Stafford and Unsubsidized Stafford and 9 percent for PLUS. Today these variable rates are tied to the 91-day Treasury bill rate. Beginning July 1, 1998, the rates will be tied to the government borrowing rate, currently the 10-year Treasury bill rate.

Repayment options

Borrowers may choose a plan that best fits their needs from among the following:

- **Standard** - fixed annual repayment amount paid within ten years;
- **Extended** - fixed annual repayment amount paid over an extended period of time (12 to 30 years), with a minimum amount due annually;

- **Graduated** - similar to Extended except that the payment amount increases by specific increments over time; and
- **Income contingent** - the borrower pays a percentage of income over a period of up to 25, years at which time the balance is forgiven.

Administrative and transition costs

The SLRA earmarked up to \$2.5 billion over fiscal years 1994-1998 to support Direct Loans administrative costs and expenses related to the phase-out of the FFEL. The largest Direct Loans administrative expense involves loan origination and servicing; other costs include systems development and maintenance; institutional eligibility determinations and program reviews; and default management. Most of these funds are awarded to private contractors—less than 10 percent supports Department staff costs. FFEL phase-out costs include guaranty agency Administrative Expense Allowances (AEA), which amounted to \$96,822,000 in fiscal year 1994. The AEA replaces the administrative cost allowance previously funded under FFEL.

In addition to administrative and transition expenses, \$750,000 of seed money was provided to establish a transitional guaranty agency. The Transitional Guaranty Agency, Inc., located in St. Paul, Minnesota was formed to perform certain administrative tasks connected with the transition and also to serve as a guarantor of last resort in the event other state and nonprofit guaranty agencies are unable or unwilling to provide such services.

Independent Audit

Direct Loans' financial statements, which follow, have been prepared and audited as a program of the Department of Education pursuant to the requirements of the Chief Financial Officers Act of 1990. They reflect the first three months of the program's operations. The independent auditor's opinion on the financial statements is presented in the following section of this report. In addition, the auditor's Reports on Internal Control Structure and Compliance with Statutes and Regulations are included.

Conclusion

As discussed above, the Department moved rapidly and successfully to implement a more efficient, less costly and more customer-friendly student loan system than existed under FFEL.

FINANCIAL REPORT



Urbach Kahn & Werlin PC
CERTIFIED PUBLIC ACCOUNTANTS

INDEPENDENT AUDITOR'S REPORT

UNITED STATES DEPARTMENT OF EDUCATION
Office of Inspector General

We have audited the principal financial statements contained in the accompanying "Annual Financial Statement" of the William D. Ford Federal Direct Loan Program (Direct Loan Program), a program of the United States Department of Education, as of and for the year ended September 30, 1994. These principal financial statements are the responsibility of the management of the United States Department of Education. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards, *Government Auditing Standards* issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin 93-06, *Audit Requirements for Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As explained more fully in Note 2, "Basis of presentation" to the principal financial statements, the Direct Loan Program reports its financial position, results of operations and changes in net position, cash flows and budgetary resources and actual expenses in accordance with the form and content requirements specified in OMB Bulletin 94-01, *Form and Content of Agency Financial Statements*. Financial statements presented in this format are considered to be prepared on a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the principal financial statements referred to above present fairly, in all material respects, the financial position of the Direct Loan Program as of September 30, 1994, and the results of its operations and changes in net position, cash flows and budgetary resources and actual expenses for the year then ended in conformity with the basis of accounting described in Note 2.

URBACH KAHN & WERLIN PC

Washington, DC
February 27, 1995



INDEPENDENT AUDITOR'S REPORT
ON INTERNAL CONTROL STRUCTURE

UNITED STATES DEPARTMENT OF EDUCATION
Office of Inspector General

We have audited the principal financial statements of the William D. Ford Federal Direct Loan Program (Direct Loan Program), a program of the United States Department of Education (the Department), as of and for the year ended September 30, 1994, and have issued our report thereon dated February 27, 1995.

We conducted our audit in accordance with generally accepted auditing standards, *Government Auditing Standards* issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin 93-06, *Audit Requirements for Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the principal financial statements are free of material misstatement.

In planning and performing our audit of the principal financial statements of the Direct Loan Program for the year ended September 30, 1994, we considered the Direct Loan Program internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the principal financial statements and not to provide assurance on the internal control structure. With respect to those controls that are material to the financial statements, we determined whether the Direct Loan Program has an internal control structure that provides reasonable assurance of achieving the internal control objectives described in the following paragraph in accordance with OMB Bulletin 93-06.

The management of the Department is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that: (1) transactions are properly recorded and accounted for to permit the preparation of reliable financial statements and to maintain accountability over assets; (2) funds, property, and other assets are safeguarded against loss from unauthorized use or disposition; and (3) transactions, including those related to obligations and costs, are executed in compliance with laws and regulations that could have a direct and material effect on the financial statements. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the Direct Loan Program significant internal control structure policies and procedures in the following categories:

**Independent Auditor's
Report on Internal Control Structure**

- Loans/financing/subsidy accounting,
- Treasury,
- Expenditures
- Budget, and
- Financial reporting.

For all of the internal control structure categories previously listed, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk. We also obtained an understanding of relevant internal control structure policies and procedures designed to determine whether data that support reported performance measures in the "Overview of the Reporting Entity" section are properly recorded and accounted for to permit preparation of reliable and complete performance information.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters, which come to our attention, relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the Direct Loan Program's ability to record, process, summarize, and report financial data consistent with the assertions of management in the principal financial statements. The reportable conditions are as follows:

CONTROLS WITHIN THE LOAN ORIGINATION, SERVICING AND REPORTING SYSTEMS NEED IMPROVEMENT

Recommendations:

1. Require the implementation of procedures to reconcile specific advances with specific loans disbursed (in addition to an all activity reconciliation which is performed on a monthly basis).
2. Require schools to use the reimbursement method if they do not adhere to the Department's cash management regulations for two consecutive months.
3. Encourage schools to transmit "Actual disbursement records" to the loan servicer (Servicing Center) the day of disbursement (or as soon as practical) to enable the Servicing Center to "book" the loan.
4. Automate and integrate the balancing functions between the Direct Loan Servicing System (DLSS) and Financial Accounting and Reporting System (FARS).
5. Provide enhanced training to schools emphasizing reconciliation and transaction dating requirements, file structures and layouts, timing requirements, and critical interfaces with DLSS.
6. Require all schools report actual loan disbursement dates in the school-based software and mainframe systems.
7. Require mainframe and combination schools perform comprehensive tests of the school-based systems before going "live".
8. Ensure periodic risk based reviews are performed of the school level quality assurance systems, general and environmental controls, backup and disaster recovery procedures, etc. to identify problem areas for particular schools and the Direct Loan Program as a whole.

**Independent Auditor's
Report on Internal Control Structure**

9. Enhance school-based software and mainframe systems to include loan limit checks at the servicer and school level.

Background:

As a result of the separate EDP systems used to originate, process, and report direct loans, the EDP systems are not completely integrated within the Direct Loan Program. Specifically, processing and reporting loan transactions involve two separate EDP systems:

- **Front-end system:** To create loan and disbursement transactions (School-based software and mainframe systems).
- **Back-end system:** To service loans and ultimately report financial activity (Direct Loan Servicing System).

Each school is responsible for ensuring the accuracy and validity of the loan origination data. Loan origination data includes the following three documents:

- Promissory note,
- Loan origination record, and
- Actual disbursement record.

The Servicing Center ensures these three loan origination documents are received and completed prior to "booking" a loan (recording the loan on the Department's system). During the past fiscal year, the schools did not remit these documents timely (specifically the actual disbursement record) because of transmission and other start up problems encountered. This resulted in a significant lag between the actual disbursement of a loan and recording of a loan receivable in the Department's records (booking the loan).

Schools initiate the reconciliation process by creating a reconciliation file in the DLSS. This file includes all loan transactions, not previously reconciled, where funds were disbursed to borrowers. The reconciliation file is transmitted electronically to the Servicing Center, where it is matched against the Servicing Center's records of each school's fund drawdowns and disbursements. An electronic file, containing records marked as reconciled or unreconciled, is transmitted by the Servicing Center back to the school. Unreconciled records are coded to indicate why no match could be made (i.e., lack of promissory note, no disbursement record, etc.). Schools must then provide the missing data or take the necessary action to ensure that the schools' records match those of the Servicing Center. In those situations where reconciliation is hampered by school software or hardware problems, or those cases where transmissions are not working, the Servicing Center staff assist in investigating and resolving the problems.

There are limited "end-to-end" system-level mechanisms within the Direct Loan Program to ensure loans originated by schools are accurately and completely reported. The reconciliation procedures (previously described) required significant manual intervention by the Servicing Center to resolve discrepancies between the loan origination records and the reconciliation files. Identifying and resolving these discrepancies is time consuming. The reconciliation process is extremely critical to ensure the loan transactions reported by schools are completely and accurately accounted for in the DLSS. If the recommendations are not implemented and the volume of direct loans increases in subsequent years, the Servicing Center's ability to manually identify, communicate, and correct exceptions will become more difficult.

**Independent Auditor's
Report on Internal Control Structure**

On December 1, 1994, revised cash management regulations were issued for the Department Title IV loan programs (including the Direct Loan Program). Amongst other things, the cash management regulations increased the allowable excess cash tolerances and described the two methods available for requesting funds: the advance payment method and the reimbursement payment method.

The Direct Loan Program is required to incorporate internal controls to monitor school drawdown requests and ensure these controls will flag any requests which appear excessive. The Direct Loan Program is also required to identify schools which have not complied with program requirements. To achieve these requirements, the Department has employed program reviewers to monitor schools participating in the Direct Loan Program and has required each school to provide an annual audit of compliance with the Student Financial Assistance program regulations.

There were significant time constraints on the Department to develop and implement the Direct Loan Program. In order to enable schools to participate in the Direct Loan Program for the academic year which began July 1, 1994, the Secretary and employees of the Department were required to accelerate the development and implementation of the standards, criteria, and procedures governing the Direct Loan Program. As a loan program relying on voluntary participation, there is a necessary emphasis on marketing the Direct Loan Program to schools as well as a need to ensure the regulations and requirements for school participation in the Direct Loan Program do not become overly burdensome or demanding on the schools. Additionally, there is Congressionally mandated legislation requiring the Direct Loan Program to disburse loans using the same methodology as the Federal PELL Grant Program (advance funded system).

Findings discussion:

Implementing recommendations 1. through 9. would enhance the Department's ability to manage this growing program. Further, we believe the Department could substantially eliminate the difficulties and delays currently encountered in the reconciliation process by strengthening certain specific controls within the Direct Loan Program discussed below. Implementation of the recommendations should not adversely affect the schools involvement in the Direct Loan Program. Implementing these recommendations will result in improvements in the reconciliation process, reporting efforts, cash management, and school level controls.

Improve reconciliation and reporting efforts: There were a number of reconciliation and accounting issues during the start-up phase of the program, including:

- Delays in receiving and reconciling loan activity from the schools,
- Difficulty with manually reconciling balances between the DLSS and FARS,
- System problems for mainframe school-based systems,
- Disbursement cancellation activity and adjustments not provided to and captured by the Servicing Center, and
- Loan limits exceeded due to input and coding errors.

The delays in receiving and reconciling loan activity stemmed primarily from the late submission of actual disbursement records by schools to DLSS and certain start-up problems in this new program. The time lag for schools participating during this initial academic year exceeded four months (in some cases). If all three loan origination records were not submitted by the schools to the Servicing Center, the loan was not "booked" and the accounting record was not created. These delays resulted in untimely accounting for loan disbursements and diminished the Department's ability to ensure schools adhered to cash management regulations. If participating schools transmitted actual disbursement records to the Servicing Center on the day of

**Independent Auditor's
Report on Internal Control Structure**

disbursement (or as soon as practical) and balancing functions within the DLSS and FARS subsystems were automated and integrated (to the extent possible and practical), the accounting and reconciliation problems identified above would be significantly reduced.

In addition, the disbursement dates reported by schools were often estimated and not actual. Specifically, 71 of the 220 (32%) disbursement dates tested during school visitations were inaccurate resulting from schools reporting estimated dates. The dating inaccuracies ranged from one to 77 days difference between the recorded disbursement date and actual disbursement date. The DLSS used the estimated disbursement dates for various Direct Loan Program calculations and reporting, including interest calculations and cash management oversight. Imprecise disbursement dates reported by schools resulted in inaccurate interest calculations and further precluded the Department from ensuring schools adhered to cash management regulations. If the Department required all schools to report actual loan disbursement dates, provided training emphasizing the required transaction dating, and included a test of the dates reported by schools in periodic risk based reviews, the occurrence of these inaccuracies will significantly decrease.

Further, if mainframe and combination school-based systems were required to be tested and proven prior to going "live" in the Direct Loan Program, problems could be detected and resolved prior to critical loan accounting periods. If the school-based software and mainframe systems were enhanced to include loan limit verification, loan limits that were exceeded would be detected promptly.

Improve ability to monitor cash management: The Excess Cash Report is a primary means of assisting the Department management with its responsibility for ensuring the schools are adhering to the Department's cash management policies. The Excess Cash Report is generated from FARS and reviewed by the Department/Office of Postsecondary Education. This report indicates daily total amounts of disbursed loans and draw downs advanced by the Department for each month. However, this report does not reconcile specific advances for a month with the specific loan disbursements for the same month. The Department was not able to quantify the amount of potential excess cash included in month end cash balances because of timing differences (previously mentioned).

All dates reflected in the Excess Cash Report are those provided by the schools themselves. As previously noted, certain schools do not report actual disbursement dates in the Student Loan Servicing System (SLSS). Estimated disbursement dates reported may result in excess cash balances not detected by the Department. Further, since the schools do not remit disbursement data to the Servicing Center on a timely basis, the Excess Cash Report does not reflect timely disbursement data and cannot be used to ensure schools adhere to cash management regulations.

Although there was no excess cash identified at seven schools visited, the potential risk of undetected excess cash balances would be diminished if the Direct Loan Program reconciled specific advances for each month with specific loans disbursed for that month. The Department should require the reimbursement method for those schools not adhering to the cash management regulations for two consecutive months. Implementation of this recommendation would assist the Department in identifying problem schools and controlling cash management as the volume of schools participating in the Direct Loan Program expands. Further, as previously noted, cash management controls would significantly improve if the Department required schools to transmit actual disbursement records on the day of disbursement (or as soon as practical), required schools to report actual disbursement dates, and provided comprehensive training to schools (including reconciliation requirements).

**Independent Auditor's
Report on Internal Control Structure**

Improve school level controls: During reviews conducted at seven schools, there were incomplete or inaccurate supporting documentation in student files and mistakes in school generated reports and documentation (financial aid and academic file documentation). Further, the schools experienced problems with school based software (and mainframe systems) and hardware. The incomplete and inaccurate documentation may result in erroneous loan transactions and reporting. Further, the system problems have resulted in delays in accounting for loan transactions. Many of these school level problem areas would be promptly identified and resolved if the Department revised cash disbursement reconciliation procedures (recommendations 1. through 3.) provided enhanced training to schools, and performed periodic risk based reviews of schools participating in the Direct Loan Program.

A material weakness is a reportable condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the principal financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, none of the reportable conditions previously described are believed to be a material weakness.

We did note other matters involving the internal control structure and its operations that we have communicated to the Direct Loan Program's management in a separate letter dated February 27, 1995.

This report is intended for the information of the Department, including management responsible for the Direct Loan Program and the Office of Inspector General of the Department. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

URBACH KAHN & WERLIN PC

Washington, DC
February 27, 1995



Urbach Kahn & Werlin PC
CERTIFIED PUBLIC ACCOUNTANTS

**INDEPENDENT AUDITOR'S REPORT
ON COMPLIANCE WITH LAWS AND REGULATIONS**

UNITED STATES DEPARTMENT OF EDUCATION
Office of Inspector General

We have audited the principal financial statements of the William D. Ford Federal Direct Loan Program (Direct Loan Program), a program of the United States Department of Education (the Department), as of and for the year ended September 30, 1994, and have issued our report thereon dated February 27, 1995.

We conducted our audit in accordance with generally accepted auditing standards, *Government Auditing Standards* issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin 93-06, *Audit Requirements for Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the principal financial statements are free of material misstatement.

Compliance with laws and regulations applicable to the Direct Loan Program is the responsibility of the Department management. As part of obtaining reasonable assurance about whether the principal financial statements are free of material misstatement, we performed tests of the Direct Loan Program's compliance with certain provisions of applicable laws and regulations. However, the objective of our audit of the principal financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion. As part of our audit, we also obtained an understanding of the process by which the Direct Loan Program identifies and evaluates weaknesses required to be reported under the Federal Managers' Financial Integrity Act. We also assessed whether the information and manner of its presentation in the "Overview of the Reporting Entity" section is materially inconsistent with the information in the principal financial statements included in the September 30, 1994 Annual Financial Statement.

The results of our tests indicate that, with respect to the items tested, the Direct Loan Program complied, in all material respects with the provisions referred to in the preceding paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that the Direct Loan Program had not complied, in all material respects, with those provisions.

This report is intended for the information of the Department, including management responsible for the Direct Loan Program and the Office of Inspector General of the Department. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

URBACH KAHN & WERLIN PC

Washington, DC
February 27, 1995

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UNITED STATES DEPARTMENT OF EDUCATION
WILLIAM D. FORD FEDERAL DIRECT LOAN PROGRAM

STATEMENT OF FINANCIAL POSITION

September 30, 1994
(DOLLARS IN THOUSANDS)

ASSETS

ENTITY ASSETS

Intragovernmental assets:

Fund balances with U.S. Treasury (Note 3) \$293,488

Governmental assets:

Credit program receivables, net (Note 4) 371,173

Advance to Transitional Guaranty Agency, Inc. (Note 5) 750

Software and equipment, net (Note 7) 12,801

Total entity assets \$678,212

LIABILITIES AND NET POSITION

LIABILITIES

Liabilities covered by budgetary resources:

Intragovernmental liabilities:

Borrowing from U.S. Treasury (Note 8) \$433,207

Governmental liabilities:

Accrued salaries and benefits 1,256

Accounts payable 27,660

Total liabilities covered by budgetary resources 462,123

Liabilities not covered by budgetary resources:

Governmental liabilities:

Accrued salaries and benefits 16

Accrued workers' compensation liability 46

Total liabilities not covered by budgetary resources 62

Total liabilities 462,185

NET POSITION (Note 9)

Unexpended appropriations 202,538

Invested capital 13,551

Future funding requirements (62)

Total net position 216,027

Total liabilities and net position \$678,212

See notes to financial statements.

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**UNITED STATES DEPARTMENT OF EDUCATION
WILLIAM D. FORD FEDERAL DIRECT LOAN PROGRAM**

STATEMENT OF OPERATIONS AND CHANGES IN NET POSITION
Year ended September 30, 1994
(DOLLARS IN THOUSANDS)

PROGRAM REVENUES AND EXPENSES

Program revenues:

Interest, non-federal	\$ 854
Interest, federal	<u>28,593</u>
Total program revenues	<u>29,447</u>

Program expenses:

Subsidy (Note 4)	17,503
Interest, non-federal	4
Interest, federal	29,450
Salaries and benefits	8,565
Travel and transportation	400
Rent, communications and utilities	1,022
Contractual services	8,119
Interagency agreements	558
Printing, materials and supplies	1,932
Depreciation and amortization	<u>2,519</u>
Total program expenses	<u>70,072</u>

NET OPERATING ACTIVITY - DIRECT LOAN PROGRAM (40,625)

FFELP mandatory administrative expense charged
to Direct Loan Program appropriation (Note 6) (96,822)

Operating activity funded by appropriations (137,447)

CHANGES IN NET POSITION

Net position, beginning of year	5,507
Appropriated funds received	<u>347,967</u>
Net position, end of year	<u>\$216,027</u>

See notes to financial statements.

**UNITED STATES DEPARTMENT OF EDUCATION
WILLIAM D. FORD FEDERAL DIRECT LOAN PROGRAM**

**STATEMENT OF CASH FLOWS
Year ended September 30, 1994
(DOLLARS IN THOUSANDS)**

CASH PROVIDED (USED) BY OPERATING ACTIVITIES

Operating cash provided	
Origination fees	\$ 15,266
Other fees	4
Interest, federal	<u>27,328</u>
Total operating cash provided	<u>42,598</u>
Operating cash used	
Interest, non-federal	(4)
Interest, federal	(29,450)
FFELP mandatory administrative expense charged to Direct Loan Program appropriation	(96,822)
Salaries and benefits	(7,417)
Travel and transportation	(400)
Rent, communications and utilities	(1,022)
Contractual services	(896)
Interagency agreements	(558)
Materials and supplies	<u>(1,745)</u>
Total operating cash used	<u>(138,314)</u>
Net cash used by operating activities	<u>(95,716)</u>

CASH PROVIDED (USED) BY INVESTING ACTIVITIES

Purchase of software and equipment	(15,064)
Advance to Transitional Guaranty Agency, Inc.	(750)
Loan repayments received	34
Loan disbursements	<u>(381,612)</u>
Net cash used by investing activities	<u>(397,392)</u>

CASH PROVIDED (USED) BY FINANCING ACTIVITIES

Appropriated funds received	347,967
Borrowing from U.S. Treasury	435,000
Repayments to U.S. Treasury for borrowings	<u>(1,793)</u>
Net cash provided by financing activities	<u>781,174</u>

Net cash provided by operating, investing and financing activities	288,066
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Fund balances with U.S. Treasury, beginning of year	<u>5,422</u>
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Fund balances with U.S. Treasury, end of year	<u>\$293,488</u>
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See notes to financial statements.

UNITED STATES DEPARTMENT OF EDUCATION
WILLIAM D. FORD FEDERAL DIRECT LOAN PROGRAM

STATEMENT OF CASH FLOWS
Year ended September 30, 1994
(DOLLARS IN THOUSANDS)

RECONCILIATION OF OPERATING ACTIVITY FUNDED BY
APPROPRIATIONS TO NET CASH USED BY
OPERATING ACTIVITIES

Operating activity funded by appropriations	<u>\$ (137,447)</u>
Adjustments to reconcile operating activity funded by appropriations to net cash used by operating activities:	
Depreciation and amortization	2,519
Allowance for subsidy	29,709
Changes in:	
Accrued interest receivable	(854)
Accounts payable	9,210
Accrued salaries and benefits	1,101
Accrued workers' compensation liability	<u>46</u>
Net adjustments	<u>41,731</u>
Net cash used by operating activities	<u>\$ (95,716)</u>

SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING
ACTIVITIES

School disbursements included in accounts payable	<u>\$ 18,450</u>
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See notes to financial statements.

UNITED STATES DEPARTMENT OF EDUCATION
WILLIAM D. FORD FEDERAL DIRECT LOAN PROGRAM

STATEMENT OF BUDGETARY RESOURCES AND ACTUAL EXPENSES
Year ended September 30, 1994
(DOLLARS IN THOUSANDS)

BUDGET

Resources	<u>\$347,967</u>
Obligations	
Direct	<u>\$259,485</u>
Reimbursed	<u>\$ -</u>

ACTUAL

Program expenses	\$70,072
FFELP mandatory administrative expense charged to Direct Loan Program appropriation	<u>96,822</u>
	<u>\$166,894</u>

BUDGET RECONCILIATION

Total expenses	\$166,894
Add: Other expended budget authority	97,751
Less: expenses not covered by available budgetary resources:	
Annual compensated leave	(10)
Unfunded workers' compensation	(46)
Depreciation and amortization	(2,519)
Allocated program expenses	<u>(2,585)</u>
Accrued expenditures	259,485
Less reimbursements	<u>-</u>
ACCRUED EXPENDITURES, DIRECT	<u>\$259,485</u>

See notes to financial statements.

**UNITED STATES DEPARTMENT OF EDUCATION
WILLIAM D. FORD FEDERAL DIRECT LOAN PROGRAM**

NOTES TO PRINCIPAL FINANCIAL STATEMENTS

NOTE 1. REPORTING ENTITY AND MISSION

The William D. Ford Federal Direct Loan Program (Direct Loan Program) (appropriation symbols 0243, X0243, and 4253) was authorized by the Student Loan Reform Act of 1993, enacted as part of the Omnibus Budget Reconciliation Act of 1993 (Public Law 103-66). The Direct Loan Program replaced the Direct Loan Demonstration Program authorized by the Higher Education Amendments of 1992 (Public Law 102-325). The Direct Loan Program is a replacement entitlement program (i.e. each direct loan dollar expended replaces a guaranteed loan dollar that would have been expended under the Federal Family Education Loan Program (FFELP)).

The Direct Loan Program provides direct financing to eligible student and parent borrowers to cover the costs of postsecondary education. Under the Direct Loan Program, the federal government (rather than private lenders) provides capital for direct loans. Capital is provided to the Direct Loan Program through appropriations and borrowings from the U.S. Treasury. Participating schools (acting on behalf of the federal government) are responsible for determining student and parent loan amounts (within limitations established by the Department of Education (the Department)), obtaining signed promissory notes, and disbursing funds to the borrowers. The Direct Loan Program uses a loan servicer (Servicing Center) to process, record, collect, and administer the loans.

The student loan programs were designed to provide eligible students and parents of students at postsecondary institutions with funding to pursue courses of study. The Direct Loan Program was designed to accomplish this mission with a streamlined application process, flexible repayment options, and a simplified disbursement and collection process.

The Direct Loan Program provided the following types of loans during the year ended September 30, 1994:

- Federal Direct Stafford/Ford Loans (Stafford): Stafford loans are provided based on financial need for undergraduate, graduate, and professional students. Under this program, the Department pays the interest while the borrower is in an in-school, grace, or deferment period.
- Federal Unsubsidized Stafford/Ford Loans (Unsubsidized Stafford): Unsubsidized Stafford loans are provided for undergraduate, graduate, and professional students without regard to financial need. The borrower is responsible for the interest throughout the entire life of the loan.
- Federal Direct Parent Loans for Undergraduate Students (PLUS): PLUS loans are provided for parents of dependent students without regard to financial need. The borrower is responsible for the interest which accrues during any period, unless the borrower qualifies for deferment.

**UNITED STATES DEPARTMENT OF EDUCATION
WILLIAM D. FORD FEDERAL DIRECT LOAN PROGRAM**

NOTES TO PRINCIPAL FINANCIAL STATEMENTS

NOTE 1. REPORTING ENTITY AND MISSION, CONTINUED

For the 1994 academic year, interest rates for Stafford and Unsubsidized Stafford loans were based on the bond equivalent yield of 91-day Treasury bills at the final auction held prior to June 1 of each year plus 3.1 percentage points. The rate cannot exceed 8.25 percent. Interest rates for PLUS were based on the 52 week U.S. Treasury bill rate plus 3.1 percentage points and cannot exceed 9 percent.

Schools participate in the Direct Loan Program as individual originators, collective (or consortium) originators or through use of an alternative originator. To participate in the program for the 1994-1995 academic year, a school was required to have a Program Participation Agreement under FFELP and enter into a similar agreement with the Direct Loan Program. For the fiscal year ended September 30, 1994, 103 schools participated in the program.

The Direct Loan Program is operated as an entitlement program within the participating educational institutions and the Department is authorized to incur obligations as necessary for mandatory program expenditures, such as payments for advances of loan funds to schools. This authority is based on the Higher Education Act, as amended. The costs of federal administration of the Direct Loan Program are mandatory, and the authority to incur obligations for these costs is limited to a total of \$2.5 billion for fiscal year 1994 through fiscal year 1998.

The principal financial statements of the Direct Loan Program reflect activities related to all Direct Loan Program loans. The principal financial statements do not include the effects of centrally administered assets and liabilities related to the federal government as a whole, such as property and equipment and borrowing by the U.S. Treasury which may be attributable, in part, to the Direct Loan Program.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Basis of presentation: These financial statements have been prepared to report the financial position, results of operations and changes in net position, cash flows, and budgetary resources and actual expenses of the Direct Loan Program of the Department, as required by the Chief Financial Officers Act of 1990 (Public Law 101-576). The Department prepared the financial statements from the books and records of the Direct Loan Program in accordance with the Direct Loan Program accounting policies, which are summarized in this note. These statements are different from the financial reports, also prepared by the Department for the Direct Loan Program pursuant to OMB directives, used to monitor and control the Direct Loan Program's use of budgetary resources.

Direct Loan Program accounting policies follow an "other comprehensive basis of accounting," comprising the following hierarchy, agreed to by the Comptroller General, the Secretary of the Treasury and the Director of the Office of Management and Budget (OMB), who are Joint Financial Management Improvement Program (JFMIP) principals:

1. The accounting principles, standards and requirements approved by the three JFMIP principals.

UNITED STATES DEPARTMENT OF EDUCATION
WILLIAM D. FORD FEDERAL DIRECT LOAN PROGRAM

NOTES TO PRINCIPAL FINANCIAL STATEMENTS

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

2. Form and content requirements in OMB Bulletin 94-01, Form and Content of Agency Financial Statements, dated November 16, 1993, and subsequent issuances.
3. Accounting standards contained in agency accounting policy, procedures manuals, and/or related guidance as of March 29, 1991, so long as they are prevalent practices.
4. Accounting principles published by authoritative standard setting bodies and other authoritative sources (1) in the absence of other guidance in the first three parts of this hierarchy, and (2) if the use of such accounting standards improves the meaningfulness of the financial statements.

OMB Bulletin 94-01 prescribes a framework for agencies to develop financial statements which provide information useful to Congress, government officials, and the public. Agencies are required to conform financial statements to the prescribed form and content of this bulletin, unless a variance is requested from and approved by OMB. OMB approved the following deviation from OMB Bulletin 94-01 in the Direct Loan Program's principal financial statements:

The Statement of Operations and Changes in Net Position follows the format suggested in the Governmental Accounting Standards Board's Codification of Governmental Accounting and Financial Reporting Standards, which identifies a separate disclosure for the total effect of operations, exclusive of appropriations and intra-governmental funding sources.

B. Basis of accounting: The Direct Loan Program's transactions are recorded on the accrual and budgetary basis of accounting. Under the accrual basis, revenues are recognized when earned and expenses are recognized when a liability is incurred, without regard to receipt or payment of cash. Payments for the administrative expense allowance (see note 6) are recorded on the cash basis. Budgetary accounting facilitates compliance with legal constraints and control over the use of federal funds. The differences between the accrual and the budgetary basis recognition of expenditures are presented in the Statement of Budgetary Resources and Actual Expenses. For purposes of that statement, obligations represent liabilities which may require payments from current or future period appropriations. As described in the next section, the Statement of Budgetary Resources and Actual Expenses reflect the transactions of the Program Account only.

C. Budget and budgetary accounting: The Federal Credit Reform Act of 1990 (CRA) was enacted to more accurately measure the costs of federal credit programs, place the cost of credit programs on a budgetary basis equivalent to other federal spending, encourage the delivery of benefits in the form most appropriate to the needs of the beneficiaries, and improve the allocation of resources among and between credit programs and other spending programs.

**UNITED STATES DEPARTMENT OF EDUCATION
WILLIAM D. FORD FEDERAL DIRECT LOAN PROGRAM**

NOTES TO PRINCIPAL FINANCIAL STATEMENTS

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

In accordance with CRA, a Program Account was established to record the budgetary activity for the Direct Loan Program, including associated subsidy costs and administrative expenses. Administrative expenses include expenses for salaries and overhead directly related to the program. Administrative expenses also include contractual services of the Servicing Center and transitional expenses, such as the administrative expense allowance paid to guaranty agencies during periods when both direct and guaranteed loan programs are in operation. The Program Account also funded the outlay of the seed money advance to establish the Transitional Guaranty Agency, Inc. Administrative expenses are recorded on the accrual basis. The subsidy costs are estimated on a net present value basis. The Program Account receives appropriations to fund these costs.

The Direct Loan Program established a non-budgetary Financing Account, which records all cash flows resulting from direct loans made during fiscal year 1994. The cash flows include the subsidy costs from the Program Account, borrowing from U.S. Treasury, interest earned on uninvested funds, loans disbursed, and student and parent loan collections received.

D. Financing sources and program revenues: The Direct Loan Program receives the majority of the funding needed to support the program through appropriations and borrowings from the U.S. Treasury. The Direct Loan Program also receives origination fees when loans are disbursed to borrowers. Origination fees were four percent of the loan amount for the current fiscal year.

E. Fund balances with U.S. Treasury: The Department has the authority to disburse U.S. Treasury funds directly to participating Direct Loan institutions. Cash receipts are processed by the U.S. Treasury. Fund balances with the U.S. Treasury are primarily appropriated funds and undisbursed U.S. Treasury borrowings available to pay current liabilities and finance subsidy expenses. Fund balances in the Financing Account are interest bearing.

F. Credit program receivables: Credit program receivables are carried at the principal amount outstanding, net of an allowance for subsidy cost. The Direct Loan Program records direct loans and interest receivable as credit program receivables. The allowance for subsidy cost represents the difference between the present value of the net cash inflows and outflows of the underlying direct loans including collections of principal and interest, interest subsidies, prepayments, defaults, delinquencies, fees, recoveries and other cash inflows and outflows. The allowance is amortized by the interest method using the interest rate originally used to calculate the present value of the direct loans when the direct loans were disbursed.

G. Software and equipment: Software and equipment are stated at cost, net of accumulated amortization and depreciation. Repairs and maintenance costs are expensed as incurred. The Direct Loan Program uses the straight line method of depreciation and amortization to allocate the costs of software and equipment over the useful lives which range between five and ten years.

UNITED STATES DEPARTMENT OF EDUCATION
WILLIAM D. FORD FEDERAL DIRECT LOAN PROGRAM

NOTES TO PRINCIPAL FINANCIAL STATEMENTS

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

H. Liabilities: Liabilities represent the amount of monies or other resources that are to be paid by the Direct Loan Program as the result of a transaction or event which has already occurred. A liability can not be paid if the Direct Loan Program does not receive an appropriation or borrowing authority. Liabilities for which an appropriation has not been enacted are classified as liabilities not covered by budgetary resources (unfunded liabilities). The majority of the Direct Loan Program's liabilities result from entitlements and the Direct Loan Program is required to pay these liabilities. Any non-entitlement liabilities of the Direct Loan Program, such as federal administrative costs, not arising from contracts, and entitlements not yet vested, can be abrogated by the government acting in its sovereign capacity.

I. Borrowings from U.S. Treasury: Borrowings from U.S. Treasury provide the majority of the annual funding of loans made by the Direct Loan Program. These loans were structured for the Direct Loan Program to make periodic principal payments to the U.S. Treasury based on repayment schedules of the loans. Interest is paid to the U.S. Treasury based on a weighted average rate determined for each year.

J. Federal Credit Reform Act of 1990: CRA and the JFMIP principals established procedures for federal agencies and departments to identify and record, for budgetary and financial accounting purposes, the costs of agency loan obligations (subsidy), as well as the administrative costs of an agency's loan program. Agencies are required to budget and account for future costs (such as below market interest rates and defaults) which will be incurred as a result of credit programs as part of the budgetary process. These expected costs (subsidy) are included as outlays of the program. The subsidized and unsubsidized cash flows are recorded in separate financing accounts. CRA requires budget authority to be available to cover the subsidy cost of all direct loans at the time funds for such loans are advanced.

Subsidies are estimated and calculated on the differences between the present value of the expected cash outflows from the Government and the present value of expected cash inflows to the Government, discounted by the U.S. Treasury rate of a similar termed instrument on the date the loan is advanced. Subsidy costs (including interest rate differentials, interest subsidies, delinquencies and defaults, fee offsets and other cash flows) associated with direct loans are recognized as costs in the year the loan is disbursed. The net present value of loans receivable at any point in time, under CRA, is the amount of the gross loans receivable reduced by an allowance equal to the present value of the subsidy costs associated with the loans.

K. Retirement plans: The majority of the Direct Loan Program's employees participate in the contributory Civil Service Retirement System (CSRS) or Federal Employees Retirement System (FERS), to which the Direct Loan Program makes matching contributions. Such contributions are recognized as expenses in the statement of operations and changes in net position. The Direct Loan Program does not report CSRS and FERS assets, accumulated plan benefits, or unfunded liabilities, if any, applicable to its employees. Reporting such amounts is the responsibility of the Office of Personnel Management.

**UNITED STATES DEPARTMENT OF EDUCATION
WILLIAM D. FORD FEDERAL DIRECT LOAN PROGRAM**

NOTES TO PRINCIPAL FINANCIAL STATEMENTS

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

L. Annual, sick, and other leave: Annual leave is accrued as it is earned and the accrual is reduced as leave is taken. Each year, the balance in the accrued annual leave account is adjusted to reflect current pay rates. To the extent current or prior year appropriations are not available to fund annual leave earned but not taken, funding will be obtained from future financing sources. Sick leave and other types of nonvested leave are expensed as taken.

M. Reporting period: The principal financial statements report on the year ended September 30, 1994. The Direct Loan Program began disbursing funds on July 1, 1994. Activity before that time related primarily to systems development and planning for the program. All of the loan activity in these principal financial statements occurred between July 1, 1994 and September 30, 1994.

NOTE 3. FUND BALANCES WITH U.S. TREASURY

Fund balances with U.S. Treasury were unrestricted and consisted of the following at September 30, 1994 (dollars in thousands):

	<u>Obligated</u>	<u>Unobligated</u>	<u>Total</u>
Revolving funds	\$ 82,279	\$ -	\$ 82,279
Appropriated funds	<u>116,297</u>	<u>94,912</u>	<u>211,209</u>
	<u>\$198,576</u>	<u>\$ 94,912</u>	<u>\$293,488</u>

NOTE 4. CREDIT PROGRAM RECEIVABLES

The Direct Loan Program provides loans under the programs described in Note 1. The Direct Loan Program records loans disbursed to students and accrued interest as credit program receivables. Loans are required to be disbursed to students within three days of the school's receipt of the advance. Any advances not disbursed to students are required to be promptly returned to the Department. The Direct Loan Program recognizes the allowance for subsidy and origination fees based on the entire amount of the loans outstanding. Adjustments to loans, allowance for subsidy, and origination fees relating to cancelled loans or other items are recorded during the period in which the transaction adjustment occurs. Adjustments through September 30, 1994 were not significant.

The Direct Loan Program loans are recorded in accordance with CRA and Federal Accounting Standards Board (FASAB) Statement Number 2. CRA and FASAB Statement Number 2 require the present value of subsidy costs, which include interest subsidies, estimated delinquencies and defaults, fee offset, and other cash flows associated with the costs of direct loans to be recognized in the year the loan was disbursed. Repayment terms (described under Note 1) vary depending on the borrower. The following is an analysis of credit program receivables and the nature and amount of subsidy allowance associated with the loans.

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NOTES TO PRINCIPAL FINANCIAL STATEMENTS

NOTE 4. CREDIT PROGRAM RECEIVABLES, CONTINUED

Loan related information (dollars in thousands)

	Credit Program Receivable Amount	Allowance for subsidy	Credit program receivable, net present value
Stafford	\$260,083	\$39,359	\$220,724
Unsubsidized Stafford	105,288	(7,039)	112,327
PLUS	<u>34,657</u>	<u>(2,611)</u>	<u>37,268</u>
	400,028	29,709	370,319
Accrued interest	<u>854</u>	<u>-</u>	<u>854</u>
	<u>\$400,882</u>	<u>\$29,709</u>	<u>\$371,173</u>

Subsidy related information (dollars in thousands)

	Appropriated subsidy received	Subsidy appropriations expensed	Unexpensed 1994 Subsidy Appropriations
Stafford	\$ 61,577	\$29,302	\$32,275
Unsubsidized Stafford	20,332	(8,803)	29,135
PLUS	<u>6,058</u>	<u>(2,996)</u>	<u>9,054</u>
	<u>\$ 87,967</u>	<u>\$17,503</u>	<u>\$70,464</u>

The subsidy estimate is stated at the net present value of the component subsidy costs (i.e. interest, interest subsidies, defaults, fees, and other cash flows) associated with direct loans. These costs are generally recognized in the year the loans are made for both accounting and budgetary purposes. The composition of subsidy expense and a reconciliation to the allowance for subsidy at September 30, 1994 are as follows:

Subsidy Expense:	
Loan defaults	\$ 45,320
Interest income	(17,218)
Fees, net (origination and payment for origination services)	(13,719)
Other	<u>3,120</u>
Total subsidy expense	17,503
Allowance for subsidy:	
Add: Fees, net	<u>13,719</u>
	31,222
Less: amortization of subsidy	<u>(1,513)</u>
Total allowance for subsidy	\$ 29,709

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NOTES TO PRINCIPAL FINANCIAL STATEMENTS

NOTE 5. ADVANCE TO TRANSITIONAL GUARANTY AGENCY, INC.

Guaranty agencies are state or nonprofit organizations which serve as an intermediary between the Department and financial institutions in the FFELP guaranteed student loan program. A transitional guaranty agency was established to provide for continuing operation of the FFELP program during all periods of time when both the FFELP and the Direct Loan Program are in parallel operation. The Direct Loan Program provided an advance of \$750 (thousand) to the Transitional Guaranty Agency, Inc. in St. Paul, Minnesota to perform certain administrative tasks and to be a guarantor of last resort.

NOTE 6. GUARANTY AGENCIES ADMINISTRATIVE COSTS

Prior to the Direct Loan Program, FFELP paid an administrative cost allowance (ACA) equal to one percent of new loan volume to all guaranty agencies. The FFELP ACA was replaced by a FFELP administrative expense allowance (AEA) which is funded by both FFELP and the Direct Loan Program. The AEA was one percent of new loan volume from July to September 1994 and was paid to the FFELP guaranty agencies to cover the cost of their administrative expenses. The AEA is recorded as loan volume activity is reported to the Department and is presented as a FFELP transitional cost rather than as a program expense of the Direct Loan Program because it is directly related to the operation of FFELP.

NOTE 7. SOFTWARE AND EQUIPMENT

Software and equipment consisted of the following at September 30, 1994 (dollars in thousands):

Software	\$ 13,587
Equipment	<u>1,761</u>
	15,348
Less accumulated amortization and depreciation	<u>(2,547)</u>
	<u>\$12,801</u>

Amortization and depreciation expense was approximately \$2,519 (thousands) for the year ended September 30, 1994.

NOTE 8. BORROWING FROM U.S. TREASURY

During fiscal year 1994, the Direct Loan Program borrowed \$435,000 (thousands) to fund loans disbursed. Direct Loan Program borrowings and repayments were as follows (in thousands):

Borrowing from U.S. Treasury, balance October 1, 1993	\$435,000
Repayments	<u>1,793</u>
Borrowing from U.S. Treasury, balance September 30, 1994	<u>\$433,207</u>

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NOTES TO PRINCIPAL FINANCIAL STATEMENTS

NOTE 8. BORROWING FROM U.S. TREASURY, CONTINUED

Interest expense, federal was comprised of the interest accrued on borrowings from the U.S. Treasury to fund advances to schools for the purpose of originating direct loans under this program, net of interest earned on uninvested subsidy and borrowed funds. Interest on the borrowing is paid annually on the last day of the fiscal year at a weighted average annual rate calculated for each cohort year. The weighted average rate paid was 6.77 percent. Interest expense was \$29,450 (thousand) for the year ended September 30, 1994.

NOTE 9. NET POSITION

Net position was comprised of the following at September 30, 1994 (dollars in thousands):

	<u>Unexpended appropriations</u>	<u>Invested capital</u>	<u>Cumulative results of operations</u>	<u>Futura funding requirements</u>	<u>Total</u>
Net position, October 1, 1993	\$ 5,257	\$ 256	\$ -	\$ (6)	\$ 5,507
Net operating activity	-	-	(137,391)	(56)	(137,447)
Appropriations received	<u>197,281</u>	<u>13,295</u>	<u>137,391</u>	<u>-</u>	<u>347,967</u>
Net position, September 30, 1994	\$ <u>202,538</u>	\$ <u>13,551</u>	\$ <u>-</u>	\$ <u>(62)</u>	\$ <u>216,027</u>

NOTE 10. INTRAGOVERNMENTAL FINANCIAL ACTIVITIES

The Direct Loan Program's financial activities interact with and to a certain extent are dependent upon the financial activities of the federal government as a whole. The Direct Loan Program's principal financial statements however are not intended to report the entity's proportionate share of the federal deficit or of public borrowing including interest thereon. Financing for budget appropriations reported on the Direct Loan Program's statements of operations and changes in net position and cash flows could be derived from either tax revenues or public borrowing or both. The ultimate source of this financing whether it be tax revenues or public borrowing, has not been specifically allocated to the Direct Loan Program.

UNITED STATES DEPARTMENT OF EDUCATION
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NOTES TO PRINCIPAL FINANCIAL STATEMENTS

NOTE 10. INTRAGOVERNMENTAL FINANCIAL ACTIVITIES CONTINUED

Federal Employees Compensation Act: The Employees Compensation Act (FECA) is administered by the U.S. Department of Labor (DOL). Actuarial liabilities have been determined for each Federal agency. The actuarial FECA liability for the Department, with offsetting expenses, has been allocated to those programs, including the Direct Loan Program, for which financial statements are prepared. DOL also renders annual FECA bills to the federal agencies, including the Department, for actual benefits paid on behalf of its employees.

Retirement plan: Direct Loan Program employees participate in one of two retirement plans. The first plan is the Civil Service Retirement System (CSRS) to which the Direct Loan Program makes matching contributions equal to seven percent of pay. The second plan, the Federal Employees Retirement System (FERS), became effective on January 1, 1987, pursuant to Public Law 99-335. Employees hired prior to January 1, 1984 can elect to join either FERS and Social Security or remain in CSRS. A primary feature of FERS is that it offers a savings plan to Direct Loan Program employees, which automatically contributes one percent of pay and matches any employee contribution up to an additional four percent of pay. In addition, for employees covered under FERS, the Direct Loan Program contributes the employer's matching share for Social Security.

CSRS and FERS are multi-employer plans. Although the Direct Loan Program funds a portion of pension benefits relating to its employees, and provides for the necessary payroll withholdings, it does not maintain or report information with respect to the assets of the plans, nor does it report actuarial data with respect to accumulated plan benefits or the unfunded pension liability relative to its employees. Reporting such amounts is the responsibility of the Office of Personnel Management.

The Direct Loan Program's contribution to both plans was approximately \$915 (thousand) for the year ended September 30, 1994.

Claims, Judgements, and Relief Acts Fund: Most legal actions which affect the Direct Loan Program are paid from the Claims, Judgements, and Relief Acts Fund maintained by the U.S. Treasury. The Direct Loan Program is not required to reimburse this fund for payments made on its behalf.

Health benefits and life insurance: The Direct Loan Program, as part of the federal government, offers health and life insurance plans, under which premium costs for health care are shared between Direct Loan Program and the employees. The substantial portion of life insurance premiums are paid for by employees. Amounts paid by the Direct Loan Program for health care and life insurance were approximately \$172 (thousand) for the year ended September 30, 1994. The Direct Loan Program does not provide health care and life insurance benefits for retired employees.

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NOTES TO PRINCIPAL FINANCIAL STATEMENTS

NOTE 11. COMMITMENTS AND CONTINGENCIES

Legal: The Department is involved in various claims and legal actions related to the Direct Loan Program arising in the ordinary course of business. In the opinion of management and legal counsel, the ultimate disposition of these matters will not have a material effect on the principal financial statements of the Direct Loan Program.

Transitional Guaranty Agency, Inc. reserves: The Transitional Guaranty Agency, Inc. (TGA) receives collections for administrative services performed in connection with the transition of the FFELP program from guarantee agencies in accordance with an Agreement for Federal Reinsurance of Loans (Agreement) between the Department and TGA. In accordance with the terms of the Agreement, the Department is entitled to the cash reserves resulting from the net operating activity of the TGA. The Department, as it deems appropriate, can recover the excess cash reserves and any assets purchased with reserve funds. These reserve balances are not reflected in the principal financial statements of the Direct Loan Program because the Department's recovery of these amounts is contingent upon the Secretary's determination such recovery would be appropriate. The total reserve fund and excess reserve fund balances (reserve funds in excess of 60 percent of expenses) at September 30, 1994 were approximately \$1.8 million and \$309 (thousand), respectively.

Loan servicing contract: During fiscal year 1994, the Department awarded a \$91.7 million contract to a loan servicer (Servicing Center). The contract includes a team of five subcontractors. The Servicing Center's responsibilities include maintaining the Department's database on direct loan recipients, providing alternate originating functions for schools unable to or who choose not to originate loans, coordinate billings and collections, and provide customer service. The \$91.7 million contract is through September 1995 with options for renewal through September 2000 (the seven year contract is estimated at \$376 million). As of September 30, 1994, approximately \$7.4 million was expended by the Department on this contract.

APPENDIX I

MANAGEMENT RESPONSE TO AUDIT RECOMMENDATIONS



UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF THE CHIEF FINANCIAL OFFICER

THE CHIEF FINANCIAL OFFICER

MAR 15 1995

Stephen A. McNamara
Assistant Inspector General for Audits
U.S. Department of Education
Washington, DC 20202

This is in response to your request for comments on the draft report on the financial statements of the Department of Education's William D. Ford Federal Direct Loan Program Principal Statements for the fiscal year ended September 30, 1994.

We appreciate the opportunity to comment on the report. As noted, the auditors concluded that the Direct Loan Principal Statements present fairly, in all material respects, its financial position as of September 30, 1994, and the results of operations, cash flows and budgetary resources and actual expenses for the year then ended. In addition, they reported no material internal control weaknesses or noncompliance with laws and regulations. We believe that this is a tribute to the Direct Loan Task Force and all of the people throughout the Department that have been working so hard to assure the success and accountability of this program.

With respect to the recommendations in the report regarding internal controls, we are in general agreement with the issues of improving the reconciliation process, improving the ability to monitor cash management, and improving school level controls. However, we need to further analyze the specific recommendations to determine the best way to proceed to achieve the desired results. We plan to do so promptly and take all appropriate corrective actions.

As a matter of fact, much has been done or is in process to address the issues raised. Improvements underway or completed include: 1) Development of a comprehensive school testing process for the data interface between the schools and the Direct Loan Servicing System; 2) Development of additional edits on loan limits in both the schools' and servicer's software; 3) Improved ED and contractor capacity to assist schools on a proactive basis; 4) Increased risk-based monitoring of schools; 5) Development of software to further enhance our quality assurance/quality control abilities; 6) Enhancement of school training; and 7) Analyzing the reconciliation process and other processes to improve the Department's capacity to monitor cash and assure accountability.


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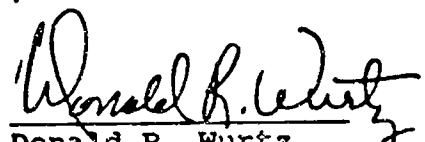
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We look forward to continuing the cooperative effort to improve program management and better serve the participants in this program and the taxpayers. If you have any questions, please contact Mitchell L. Laine, Deputy Chief Financial Officer, at 401-0207, Linda Paulsen, Director, Accounting and Financial Management Services, Office of Postsecondary Education, at 708-4664, or Diane Sedicum, Chair, Direct Loan Task Force, at 708-9951.

Sincerely yours,



Leo Kernfeld
Special Advisor to the
Secretary



Donald R. Wurtz
Chief Financial Officer